No. 708

In the Supreme Court of the United States

OCTOBER TERM, 1941

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CREDIT ALLIANCE CORPORATION

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE PETITIONER

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OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 13–24) is reported at 42 B. T. A. 1020. The opinion of the Circuit Court of Appeals (R. 32–38) is reported at 122 F. (2d) 361.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on July 21, 1941 (R. 39). The petition for a writ of certiorari was filed on October 21, 1941, and granted on November 24, 1941 (R. 42). The

jurisdiction of this Court is conferred by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

In 1936 the taxpayer corporation made a liquidating distribution of earned surplus to its parent corporation, which resulted in no taxable gain or loss to the parent corporation under Section 112 (b) (6) of the Revenue Act of 1936. For the purpose of computing undistributed profits surtax, is taxpayer entitled to a dividends paid credit under Section 27 (f) of the Revenue Act of 1936?

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set out in the Appendix, *infra*, pp. 37–58.

STATEMENT

The facts were stipulated and found by the Board as stipulated (R. 10–12, 14). They may be summarized as follows:

Taxpayer corporation was organized in 1922, under the laws of New York, and was formally dissolved in July 1937. Commercial Credit Company,[1] a Delaware Corporation, owned 99.63 percent of taxpayer's outstanding capital stock on December 1, 1936, and continued to own the same percentage until taxpayer was dissolved. (R. 10–11).

[1] Hereinafter referred to as the parent corporation.

Dissolution and liquidation of taxpayer corporation was decided upon in 1936 and carried out during the years 1936 to 1938, inclusive (R. 11–12). In 1936 taxpayer made a distribution in liquidation of $8.80 a share (R. 11). Of this amount $1.80 a share or a total of $950,734.80 was distributed out of earned surplus (R. 11); the minority stockholders received .37 percent of that amount or $2,506.40, and the parent corporation, Commercial Credit Company, 99.63 percent or $947,228.40 (R. 11).

To the extent that the minority stockholders received more than they had paid for their stock and under familiar provisions of the Revenue Acts they were taxed on their gains in accordance with the general rule. See Revenue Act of 1936, Sections 111, 112, 115. Section 112(b), however, made certain exceptions to the general rule, one of which applied to the parent corporation. Section 112(b) (6), provided that no gain or loss should be recognized to a corporation which received property in complete liquidation of a subsidiary in which it had had 80 percent ownership and control. Because of its preponderant stock ownership in taxpayer, therefore, any gain or loss which the parent corporation may have realized upon the receipt of taxpayer's assets in liquidation was not recognized for tax purposes (R. 12). And since the parent corporation did not distribute to its shareholders the assets so received (R. 12), the current earnings which were distributed to the parent were never the subject of the income tax.

In addition to the income tax, the Revenue Act of 1936 imposed upon corporations an undistributed profits surtax for the very purpose of reaching and taxing corporate earnings which were not distributed so as to be taxed to the stockholders. A graduated surtax was levied upon "undistributed net income". Section 14. "Undistributed net income" was to be calculated by making minor adjustments to the ordinary corporate net income and subtracting two credits: (1) a credit for sums required to be set aside by certain contracts restricting the payment of dividends and (2) a "dividends paid credit" for certain corporate distributions specified in Section 27, which may be generally characterized as distributions on which the shareholders would be subject to tax. Section 27 (f) dealt specifically with distributions in liquidation, such as taxpayer made, and allowed a dividends paid credit for "the part of such distribution which is properly chargeable to earnings or profits accumulated after February 28, 1913." The Treasury regulation promulgated under this section pointed out that there was a "distribution of earnings" in the tax sense only when a gain or loss was recognized under section 112, and therefore expressly denied a credit for amounts distributed in liquidation by a subsidiary to a parent which owned more than 80 percent of its stock, unless the parent in turn distributed the amounts to its shareholders as

dividends, in which case the credit was allowed. Also Section 27(h) provided:

> *Nontaxable Distributions.*—If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made, no dividends paid credit shall be allowed with respect to such part.

As stated above, the parent corporation by virtue of Section 112 (b) (6) was not taxed upon any gain which it may have realized upon liquidation of taxpayer and did not declare any dividends on account of the property which it received. The taxpayer, nevertheless, in computing its undistributed profits surtax for the year 1936, claimed a "dividends paid credit" for the full amount of the distribution out of earned surplus, $950,734.80 (R. 4).

The Commissioner allowed the credit to the extent of the amount distributed to the minority stockholders but disallowed it to the extent of $947,228.40, the amount distributed to the parent corporation (R. 7). Accordingly, the Commissioner determined a deficiency of $121,814.49 in taxpayer's undistributed profits surtax for 1936.

Taxpayer filed a petition for redetermination. Before the Board of Tax Appeals the Commissioner contended that the latter amount was not a

"distribution * * * properly chargeable to the earnings or profits" of taxpayer within the meaning of Section 27 (f) even though it was charged to post-1913 earnings on the taxpayer's books,[2] on the ground that under Section 112 (b) (6) the distribution was not one upon which a gain was recognized to the parent corporation; and he also urged that Section 27 (h) forbade the credit because the distribution was not "a taxable dividend in the hands of * * * the shareholders."

The Board of Tax Appeals held that there was no deficiency (R. 24). The court below affirmed (R. 39).

The decision below conflicts with *Centennial Oil Co.* v. *Thomas,* 109 F. (2d) 359 (C. C. A. 5th), certiorari denied, 309 U. S. 690, the Court brought the case here. The same question was decided adversely to the Commissioner in *Commissioner* v. *Kay Mfg. Corp.,* 122 F. (2d) 443 (C. C. A. 2d), now pending in this Court on petition for a writ of certiorari as No. 709, this Term.

SPECIFICATION OF ERROR TO BE URGED

The Circuit Court of Appeals erred in holding that taxpayer corporation was entitled, under Section 27 (f) of the Revenue Act of 1936, to a dividends paid credit for the tax-free liquidating distribution to its parent corporation.

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[2] Since taxpayer was formed in 1922 it is undisputed that all of its earnings were accumulated after February 28, 1913.

SUMMARY OF ARGUMENT

Article 27(f)–1(a) of Treasury Regulations 94 flatly denies the dividends paid credit which taxpayer seeks, on the ground that no gain or loss was recognized to the parent corporation under Section 112 (b) (6). Section 112 (b) (6) provides that no gain or loss shall be recognized for tax purposes when a subsidiary distributes its assets in liquidation to a parent corporation owning a preponderant part of its stock. Underlying Section 112 (b) (6) is the concept that in those circumstances there has been no real distribution or division of the earnings of the enterprise despite the formal transfer from one corporate form to another. Taxpayer and its parent corporation took advantage of this rule. Article 27(f)–1(a) does no more than apply the same principle in determining whether there has been a "distribution * * * chargeable to the earnings" within the meaning of Section 27 (f). If this Treasury interpretation is at all reasonable, it must be sustained.

The purpose of the undistributed profits surtax was to levy upon all corporate earnings which were not distributed so as to be taxable to the individual shareholders. In drafting Section 27 (f), therefore, Congress was required to correlate it with Section 112 and other sections determining what distributions in liquidation were taxed in the hands of the shareholders. The phrase "distribution

chargeable to earnings and profits accumulated after February 28, 1913" was a suitable formula for this purpose; in tax law as distinguished from accounting, it had been used as not only excluding distributions chargeable to capital or to pre-1913 earnings but as also excluding transfers of earned surplus accompanying a mere change in corporate form of the kind required to be ignored by Section 112 and kindred sections. When the Revenue Act of 1936 was enacted, Congress showed that it knew and approved this usage. When the Revenue Act of 1938 was enacted, Congress declared in Section 115 (h) that the term should be considered to have been used in its tax sense throughout the Act and it was expressly stated in the committee reports that no change in existing law was thereby intended. At the same time Section 27 (f) was reenacted without change as Section 27 (g) of the 1938 Act. Thus Congress twice gave approval to the interpretation expressed in Article 27(f)-1(a) of the 1936 regulations.

Section 27 (h) declares that no dividends paid credit shall be allowed for distributions which are not "taxable dividend[s] in the hands * * * of the shareholders * * *." It is a general subsection with the caption *"Nontaxable Distributions"* and is intended to require the preceding subsections in Section 27 to be interpreted consistently with the purpose of the Act to subject all corporate earnings to tax either in the hands of

shareholders or as undistributed profits. The word "dividend" must be read in conjunction with the caption *"Nontaxable Distributions"* as including a liquidating dividend. Thus, Section 27 (h) states the obverse of Section 27 (f) and shows the Treasury's interpretation of Section 27 (f) to be correct.

The strongest case which taxpayer can make is that Section 27 (f) may use the term "distribution chargeable to earnings and profits" in the accounting sense. But it cannot be denied that Congress knew and approved using the phrase with the tax meaning which the Treasury attributes to the words, nor can it be gainsaid that the regulation carries out the purposes of the undistributed profits tax in a just and reasoned manner. In such circumstances the regulation is controlling.

ARGUMENT

TAXPAYER IS NOT ENTITLED TO A CREDIT IN COMPUTING ITS UNDISTRIBUTED PROFITS SURTAX FOR THE TRANSFER OF ITS EARNED SURPLUS IN LIQUIDATION TO A PARENT CORPORATION OWNING 80 PER CENT OF ITS CAPITAL STOCK

The Board and the court below decided the case as if no Treasury regulation were involved; they held, in effect, that Section 27 (f) should be read to allow a credit for all distributions in liquidation which were chargeable to earned surplus on the corporate books, and that read in this manner, Section 27 (f) controlled the somewhat inconsistent pro-

visions of Section 27 (h), even though no gain or loss upon the liquidation was recognized to the parent corporation. We submit that the Board and the court below erred. We shall show (1) that under the applicable Treasury regulation taxpayer was not entitled to the credit claimed; (2) that the words "distribution * * * chargeable to earnings and profits," which appear in Section 27 (f), are words of art used to include only distributions which result in a taxable gain or loss to the distributee and to exclude the transfers of earned surplus occurring in a change of corporate form unaccompanied by any change in substantial ownership and control; (3) that Section 27 (h) shows that this is the true meaning of Section 27 (f); and (4) that since the applicable regulation is in any event a reasonable interpretation of Section 27 (f), it must be sustained.

1. UNDER THE APPLICABLE TREASURY REGULATIONS A SUBSIDIARY CORPORATION IS NOT ENTITLED TO A DIVIDENDS PAID CREDIT FOR DISTRIBUTIONS IN LIQUIDATION TO ITS PARENT CORPORATION ON WHICH NO TAXABLE GAIN OR LOSS IS RECOGNIZED UNDER SECTION 112 (b) (6)

The 1936 transfer of earned surplus from taxpayer to its parent corporation did not result in a taxable gain or loss to the latter. Revenue Act of 1936, Section 112 (b) (6). The parent corporation took taxpayer's basis for all tax purposes in connection with any property distributed in kind. Section 113 (a) (15). The tax effect of the trans-

fer (or distribution in liquidation) was quite different, therefore, from its effect upon the corporate books, for according to ordinary accounting concepts taxpayer had distributed its earnings and the parent corporation had realized a gain or loss upon its investment in taxpayer's stock. Thus, the accountant gives effect to the change of corporate form whereas Section 112 (b) (6) (and companion provisions dealing with similar corporate reorganizations) is framed upon the practical realization that no real division or distribution of the profits of the enterprise occurs when a subsidiary liquidates by transferring its assets and surplus to a parent corporation owning a preponderant part of its stock.

Despite these circumstances taxpayer seeks a "dividends paid credit" for the distribution in liquidation to its parent corporation, on the ground that accounting standards must be used in applying the phrase in Section 27 (f), "distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913 * * *."

The applicable Treasury regulation, however, flatly denies the credit which taxpayer seeks. Article 27 (f)–1 (a) of Treasury Regulations 94 states that a distribution in complete or partial liquidation of a corporation is treated by the Revenue Act as a distribution properly chargeable to earnings only if "under the provisions of section 112, the

gain or loss, if any," realized by the shareholders "is recognized" for tax purposes. It provides:

> * * * certain transactions described in sections 112 and 115 are treated, for the purposes of the Act, not as distributions to the shareholders of earnings or profits, but as transfers of such earnings or profits intact to another corporation in whose hands such earnings or profits, being available for distribution by it as dividends to its shareholders, have essentially the same status for the purposes of the Act as earnings or profits derived from its own operations. Characteristic of these transactions is the circumstance that the gain or loss realized from the receipt by the shareholders of property is not recognized by the Act. *No dividends paid credit is allowable with respect to such transactions.* [Italics added.]

Article 27 (f)–1 (c) allows a credit to be claimed for the subsidiary if the parent corporation in the same year passes the earnings on to its shareholders so that a real distribution is made.

Reduced to their essential meaning these provisions of Article 27 (f)–1 require only that the changes in corporate form which Congress declared insignificant for tax purposes in Section 112 shall also be ignored in applying Section 27 (f). Unless this interpretation is so unfaithful to the statute as to be unauthorized, the decision below must be reversed. The regulation was promulgated in a field of great technical difficulty requiring novel pro-

visions to be woven into interrelated sections of unusual complexity so as to achieve harmonious administration. In such circumstances and in view of the fact that the Treasury participated in drafting the act, the Treasury regulation should be sustained, if at all reasonable. *United States* v. *Joliet & Chicago R. R.*, No. 151, this Term, decided January 19, 1942; *Helvering* v. *Wilshire Oil Co.*, 308 U. S. 90; *Maryland Casualty Co.* v. *United States*, 251 U. S. 342, 349; *Spring City Co.* v. *Commissioner*, 292 U. S. 182, 189; cf. *Textile Mills Securities Corp.* v. *Commissioner*, No. 34, this Term, decided December 8, 1941.

2. THE PURPOSES OF THE UNDISTRIBUTED PROFITS SURTAX AND THE HISTORY OF THE PHRASE "DISTRIBUTION CHARGEABLE TO EARNINGS AND PROFITS" SHOW THAT THE APPLICABLE REGULATION INTERPRETS SECTION 27 (f) CORRECTLY

The broad plan of the Revenue Act of 1936 was to tax distributed corporate earnings in the hands of individual shareholders and to surtax undistributed earnings to corporations. This would place their fair share of the burden upon investors who could afford to leave earnings undistributed in the corporate treasury. See Message of the President to Congress, March 3, 1936, H. Doc. 418, 74th Cong., 2d Sess., pp. 2–3; H. Rep. 2475, 74th Cong., 2d Sess., pp. 3–5. To carry out the first branch of the plan, taxes upon individual shareholders were in-

creased by subjecting dividends to the normal tax.[3] To carry out the second, the undistributed profits surtax was generally levied for the first time upon the "undistributed net income" of corporations,[4] including undistributed income accruing from dividends by other corporations. Sections 14, 21, cf. Sections 13 (a) (2), 26 (b). Stated simply, the surtax was levied upon an amount (called "undistrib-

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[3] Theretofore dividends had been exempt from the normal tax upon individuals. See, *e. g.*, Revenue Act of 1934, c. 277, 48 Stat. 680, Section 25 (a) (1), allowing a credit for such dividends. This provision was omitted from the 1936 Act.

[4] The new plan was plainer in the form in which the Revenue Bill of 1936 (H. R. 12395, 74th Cong., 2d Sess.) passed the House and reached the Senate than it was in the bill as it became law. The House bill subjected dividends to the normal tax when received by individuals but provided for no normal income tax on corporations. There was a graduated tax which could be entirely avoided if the entire adjusted net income of a corporation was distributed, but which began to be imposed if as little as 1 percent was retained. In the law as finally enacted a normal tax upon corporate income was restored (Section 13) and combined with a surtax on undistributed income (Section 14).

Earlier undistributed profits tax provisions had penalized the accumulation of corporate earnings for the express purpose of avoiding surtaxes upon the individual shareholders. Revenue Acts of 1921, c. 136, 42 Stat. 227, 1924, c. 234, 43 Stat. 253, and 1926, c. 27, 44 Stat. 9, Section 220 (a); Revenue Acts of 1928, c. 852, 45 Stat. 791, and 1932, c. 209, 47 Stat. 169, Section 104 (a); Revenue Acts of 1934, c. 277, 48 Stat. 680 and 1936, c. 690, 49 Stat. 1648, Section 102 (a). Cf. Income Tax Act of 1913, c. 16, 38 Stat. 166, Section II A, subdivision 2; Revenue Act of 1916, c. 463, 39 Stat. 756, Section 3; Revenue Act of 1918, c. 18, 40 Stat. 1057, Section 220. Also the undistributed income of personal holding companies had been surtaxed. Revenue Acts of 1934 and 1936, Section 351.

uted net income") calculated by making adjustments to the ordinary corporate net income[5] and then subtracting a "dividends paid credit" for distributions to shareholders. Sections 14, 27. Consequently, in drafting the Act the critical provisions were those defining the corporate distributions on account of which a "dividends paid credit" could be deducted. To execute the plan successfully they would have to be woven into the existing framework of the Revenue Acts and into the whole body of tax law so that the credit would be allowed for all distributions normally taxed to their recipients and denied for those which were tax free.

Section 27 (f) was one of these critical provisions for its purpose was to define the distributions in liquidation for which a credit should be allowed. Such distributions were not "dividends" in the tax sense. See Sec. 115 (c); *Hellmich* v. *Hellman*, 276 U. S. 233. But to the extent that they represented current net earnings, their division among the shareholders would normally result in the receipt by the latter of taxable gains, and in such cases allowance of a credit to the liquidating corporation would be within the ambit of the scheme.[6] On the

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[5] The principal adjustment is a credit for sums required to be set aside by certain contracts restricting the payment of dividends. Section 26 (a).

[6] One hundred per cent of such gains is taxable to the shareholders if the liquidation is only partial, and to corporate shareholders even if the liquidation is complete. The gain received by an individual from a distribution in complete liquidation is wholly or partly taxed, depending upon the period for which the stock has been held; the percentage

other hand, a distribution from one corporation to another even of earnings accumulated after 1913 would not result in a tax if the transfer were so formal that Section 112 required it to be ignored, as, for example, in the present case. Faithfulness to the purposes of the Act, therefore, would require the credit in these latter instances to be denied under Section 27 (f) by using words which correlated that section with Section 112.

To achieve the requisite correlation, Congress deliberately chose the words "distribution * * * chargeable to earnings and profits accumulated after February 28, 1913." They had acquired through judicial decision and congressional usage a well understood tax meaning as applied to distributions in liquidation; specifically, they carried with them in addition to their accounting meaning the concept underlying Section 112, that the tax law should ignore mere changes in cor-

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ranges from one hundred per cent for a holding period of a year or less down to thirty per cent for a holding period of more than ten years. Sections 115 (c), 117. One purpose of these percentage provisions was to "give a proper recognition to the length of time during which the profit or loss has accrued." See the remarks of Senator Harrison, Chairman of the Senate Finance Committee, 78 Cong. Rec. 5846. Cf. *Helvering* v. *Hammel*, 311 U. S. 504. The object was to tax a part of the gain which was commensurate with the current accrual of gain. That part of the distribution attributed to current earnings in computing the undistributed profits tax may be considered to be included in the part taxed as a gain to the shareholders for, by hypothesis, it accrued currently.

porate form and should not recognize for tax purposes whatever "distribution" may be said to take place for accounting purposes when earned surplus is transferred intact from one corporation to another under the same ownership and control.

Commissioner v. *Sansome*, 60 F. (2d) 931 (C. C. A. 2d), certiorari denied, 287 U. S. 667, is the leading case. The assets of one corporation had been transferred to a new corporation in exchange for the issuance of the latter's shares to the stockholders of the first. By ordinary accounting principles the old corporation received the stock of the new corporation, and distributed it to its stockholders, thereby effecting a liquidating distribution of capital and earnings. All its former assets became capital of the new corporation and a subsequent distribution of any part of them to the shareholders of the new corporation was by accounting standards a proper charge to capital account. Nevertheless, the court held that the subsequent distribution by the new corporation was a "distribution of earnings and profits" because the reorganization did not affect the status of the earnings and profits of the old corporation for tax purposes. The court's view was that the sections which permitted the reorganization to be accomplished without recognition of gain or loss to the transferee required the venture to be treated as uninterrupted for other tax purposes notwithstanding the change in corporate form. Necessarily the *Sansome* case also decided that the

liquidation of the old corporation did not result in a "distribution of earnings and profits" in the tax sense; otherwise they would not have remained intact for distribution to the shareholders of the new corporation.

The *Sansome* decision, of course, was not limited to its particular facts. In the presence of a specific provision which was inapplicable because it stated only a part of the principle,[1] the *Sansome*

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[1] There had been provisions in the Revenue Act of 1934 and prior acts, applicable to transactions before January 1, 1934, that tax-free reorganization distributions of securities should not be deemed distributions of earnings for the purpose of determining the taxability of subsequent distributions by the same corporation. Revenue Act of 1934, c. 277, 48 Stat. 680, Section 115 (h); Revenue Acts of 1932, c. 209, 47 Stat. 169, and 1928, c. 852, 45 Stat. 791, Section 112 (h); Revenue Acts of 1926, c. 27, 44 Stat. 9, and 1924, c. 234, 43 Stat. 253, Section 203 (g). This provision was aimed primarily at the case where corporation A transfers some of its assets to B for the latter's stock which is distributed to A's stockholders without retiring A's stock. Prior to 1934 such a distribution was tax free. Revenue Acts of 1932 and 1928, Section 112 (g); Revenue Acts of 1926 and 1924, Section 203 (c). It was not tax free under the 1934 Act. Cf. H. Rep. No. 704, 73d Cong., 2d Sess., p. 14 (1939-1 Cum. Bull. (Part 2) 554, 564); S. Rep. No. 558, 73d Cong., 2d Sess., p. 16 (1939-1 Cum. Bull. (Part 2), 586, 598). It is for this reason that Section 115 (h) of the 1934 Act is stated to apply only to distributions before January 1, 1934. See H. Rep. No. 704, *supra*, pp. 26-27. S. Rep. No. 558, *supra*, p. 33. Thus, specific provisions applicable to the transferor had been in force for some years prior to the *Sansome* case and decisions following it. These cases, however, dealt primarily with the earnings of the transferee corporation, and held without benefit of any similar provision that the earnings were enhanced by what had been the profits of the transferor.

case established the broad interpretative rule that a "distribution of earnings and profits" (or a "distribution * * * chargeable to earnings and profits") meant a substantial division to the equitable owners, and not a mere "transfer intact" in the course of a change in the corporate form which lacked tax significance under Section 112. Even before the enactment of the Revenue Act of 1936, the *Sansome* case had been followed in such a number of subsequent decisions that its doctrine may fairly be said to have become an integral part of the tax law. *Murchison's Estate* v. *Commissioner*, 76 F. (2d) 641 (C. C. A. 4th); *Fain* v. *Commissioner*, 76 F. (2d) 1008 (C. C. A. 5th), certiorari denied, 296 U. S. 588; *United States* v. *Kaufman*, 62 F. (2d) 1045 (C. C. A. 9th); *Baker* v. *Commissioner*, 80 F. (2d) 813, 815 (C. C. A. 2d); *Harter* v. *Helvering*, 79 F. (2d) 12, 13 (C. C. A. 2d).

When the Revenue Act of 1936 was enacted, Congress partially embodied the doctrine of the *Sansome* case into Section 115 (h) and gave its approval to the doctrine as a whole. Section 115 (h) was added to provide that a distribution of stock or securities should not be deemed a distribution of earnings or profits of any corporation if no gain or loss to the distributee was recognized. Speaking of such tax free distributions, the Senate Finance Committee gave its approval to the principle stated in the *Sansome* case (S. Rep. 2156, 74th Cong., 2d Sess., p. 19 (1939–1 Cum. Bull. (Part 2) 678, 690)):

> In such cases, earnings or profits remain intact and hence available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. This rule is stated only in part in section 115 (h) of the Revenue Act of 1934, and corresponding provisions of prior Acts, but is the rule which is applied by the Treasury and supported by the courts in *Commissioner* v. *Sansome* (60 Fed. (2d), 931); *United States* v. *Kaufman* (62 Fed. (2d), 1045); *Murcheson* v. *Comm.* (76 Fed. (2d), 641). While making no change in the rule applied under existing law, the recommended amendment is desirable in the interest of greater clarity.

Section 115 (h), as amended applied only to the distribution of securities but there can be no doubt that its purpose was to "carve out * * * a defined group of cases to which a rule of thumb would be applied" * without narrowing the broader principle. The very considerations which led to the rule of thumb in the case of securities applied with equal force in the case of money and other property. The existing law was that there was no "distribution of earnings and profits" regardless of the medium of exchange, if the distribution resulted in no gain to the transferee because there was only a change in corporate form. And, the

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* *Helvering* v. *Clifford*, 309 U. S. 331, 337–338.

committee report cited shows plainly that Congress did not intend to change the existing law.

Turning back now to the problem before Congress in drafting Section 27 (f), it is apparent both that the phrase "distribution * * * chargeable to the earnings" was a convenient formula which would accomplish the necessary correlation with Section 112 and also that Congress was familiar with the formula. Taxpayer was right in urging in the court below that Congress intended to deny the credit for distributions chargeable to capital or to profits accumulated before 1913 and that the phrase used accomplishes those purposes. But the difficult problem was to correlate the provisions allowing the credit with the provisions of Section 112 determining whether any gain or loss should be recognized. See pp. 13–16, *supra*. Since Congress knew and approved the doctrine that for the purposes of existing Revenue Acts there was no "distribution of profits" where under Section 112 no gain or loss was recognized, Congress must have used that phrase to solve the more difficult problem as well as the simple one.

The Treasury adopted the foregoing analysis of the Revenue Act of 1936. Regulations 94 applied the doctrine of the *Sansome* case to all corporate distributions, whether of securities, and so controlled by Section 115 (h), or of money or other property, and so controlled only by the principles announced in the *Sansome* case. See Article 115–

11 (first paragraph). Article 27 (f)-1 (a) required like disregard of formal corporate changes in interpreting Section 27 (f). (See pp. 10–13, *supra*.)

In the Revenue Act of 1938 these interpretations received Congressional approval. Section 115 (h) was amended in the Revenue Act of 1938 to make the rule express:

> The distribution (whether before January 1, 1938, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property or money, shall not be considered a distribution of earnings or profits of any corporation—
>
> (1) if no gain to such distributee from the receipt of such stock or securities, property or money, was recognized by law * * *

And Section 27 (f) was reenacted without change as Section 27 (g). These provisions leave no doubt that under the 1938 Act a tax free distribution of earnings in liquidation is not a "distribution * * * chargeable to the earnings" within the meaning of Section 27 (g); for Section 115 (h) defines what is a distribution of, or properly chargeable to, earnings for the purposes of Section 27 (g) as well as for the purposes of other parts of Section 115.* The legislative history and the express

* The Board itself has recognized that in the 1936 Act Section 115 (h) limited Section 27 (f). *Reed Drug Co.* v.

retroactivity of Section 115 (h) to past transactions affecting 1938 taxes show that the amendment to Section 115 (h) did not introduce new law but was "a more explicit expression of the purpose of the prior law."[10] The Senate Committee made that entirely plain (S. Rep. No. 1567, 75th Cong., 3d Sess., pp. 18–19 (1939–1 Cum. Bull. (Part 2) 779, 792)):

Commissioner, 44 B. T. A. 573, now pending on appeal in the Circuit Court of Appeals for the Sixth Circuit.

Section 115 is by its very nature a definitive section, intended to establish principles governing the application of other provisions of the tax statute. This is made specific by the opening subdivisions which speak for the purposes of "this title" and "this Act." Section 115 (a) and (b) (Appendix, *infra*). Section 115 (h) is not said or implied to be of narrower scope.

The close relationship between Section 27 and Section 115 is readily apparent. It is clear, for instance, that when Section 27 (a) speaks of "dividends paid" it means dividends as defined in Section 115 (a), subject to such modifications as are specifically made by Section 27 itself. A distribution of capital would clearly give rise to no dividends credit because it would not be a dividend under Section 115. Section 115 (e) is specifically mentioned in Section 27 (e). The regulations promulgated under Section 27 contain numerous references to Section 115. See, *e. g.*, Regulations 94, Article 27 (f)–1 and Section 27 (h)–1. Though Section 27 (f) specifically alters the concept of Section 115 by treating some distributions in liquidation as dividends, for credit purposes, there is every reason to suppose that its expressions, such as "amounts distributed in liquidation" and "properly chargeable to the earnings or profits accumulated after February 28, 1913," were used in the same sense here as in other provisions of the Act.

For instance, if, pursuant to a plan, corporation A transferred all of its assets to corporation B for all of B's stock,

Under existing law, distributions of any property by a corporation which under the provisions of section 112 (b) or (c) are received by the shareholder without the recognition of gain to him (irrespective of what basis the property takes in the hands of such shareholder) are not regarded as being in any respect distributions of earnings or profits. Consequently, such earnings or profits remain unimpaired out of which taxable dividends may subsequently be declared either by the corporation making the distribution or by another corporation which, as to property acquired in an exchange described in section 112, takes in whole or in part the transferor's basis, so that the earnings or profits of the transferor corporation

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and then proceeded to liquidate partially by distributing half of the B stock in exchange for half of its own, there would be a tax-free reorganization and exchange under Section 112 (b) (3), 112 (b) (5), and 112 (g) (1) (C). Section 115 (c) says that the portion of a distribution in partial liquidation which is "properly chargeable to capital account" shall not be considered a distribution of earnings, and implies that the rest shall be. But it cannot be doubted that in the case supposed this provision. There was no distribution properly chargeable to earnings within the implication of Section 115 (c) because Section 115 (h) establishes that there has been no distribution of earnings of "any corporation." Likewise there was no "distribution properly chargeable to earnings" in Section 27 (f).

[10] *Jordan* v. *Roche*, 228 U. S. 436, 445; *Helvering* v. *N. Y. Trust Co.*, 292 U. S. 455, 469. Accord, *Burnet* v. *Guggenheim*, 288 U. S. 280, 283; *Higgins* v. *Smith*, 308 U. S. 473, 479–480; *White* v. *Winchester Country Club*, No. 63, this Term, decided January 12, 1942.

become in whole or in part the earnings or profits of such other corporation.

In view of the fact that sections 112 (b) (6) and (7) permit the distribution of property (including money), in addition to stock or securities, without the recognition of gain to the distributee, appropriate changes are made in section 115 (h) of the House bill in the interest of added clarity.

This development of Section 115 (h) of the 1938 Act, therefore, and the reenactment of Section 27 (f) without change after the Treasury regulations had applied uniformly through the Act the concept of a "transfer intact," are such evident congressional approval of the original regulations [11]

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[11] Cumulative evidence showing the conviction of Congress that the *Sansome* principle has long pervaded the Revenue Acts, and thus supporting Article 27 (f)-1 (a), is contained in Section 501 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, inserting subdivisions (l) and (m) in Section 115 of the Internal Revenue Code, which stated that the earnings of a corporation shall be deemed increased or decreased by gain or loss from the sale or disposition of property only to the extent that the gain or loss is recognized for tax purposes. This provision was made retroactive for all tax years, except as to cases already in litigation. It was intended to nullify the departure from the *Sansome* principle in cases like *Commissioner* v. *F. J. Young Corp.*, 103 F. (2d) 137 (C. C. A. 3d), where property was transferred from corporation A to corporation B for the latter's stock. Despite the fact that the exchange was tax free the *Young* case held that the earnings of A were increased, and consequently that a subsequent distribution by A was a distribution of those earnings. In the view of Congress this represented a misapprehension of the scheme of the Revenue Acts, as the Com-

that the courts cannot disregard their force. Cf. *Burnet* v. *Guggenheim*, 288 U. S. 280; *White* v. *Winchester Country Club*, No. 63, this Term, decided January 12, 1942; *Helvering* v. *Wilshire Oil Co.*, 308 U. S. 90, 99; *Helvering* v. *Winmill*, 305 U. S. 79, 83; *Morgan* v. *Commissioner*, 309 U. S. 78, 81.[12]

The circuit court of appeals, however, was not persuaded by these considerations and held that Section 27 (f) should be read as an accountant would read it. The court stated that the earnings transferred from subsidiary to parent corporation would be subject to the undistributed profits tax in the hands of the latter unless it distributed them, and the court accepted the taxpayer's argument that Section 27 (f) must be given its accounting rather than its tax meaning so that it would encourage instead of deter the abolition of unnecessary corporate chains. We submit that these conclusions spring from three misconceptions.

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mittee Reports show. See H. Rep. 2894, 76th Cong., 3d Sess., pp. 41–42; S. Rep. 2114, 76th Cong., 3d Sess., p. 25. This statute approved Treasury Regulations 94 and 101, Article 115–3.

[12] The dividends credit is still important in the computation of surtax on personal holding companies and improperly accumulated corporate surplus. Internal Revenue Code, Sections 27, 102, 500–505. Cf. Revenue Act of 1938, Sections 27, 102, 401–406; Revenue Act of 1936, Sections 27, 102, 351. It was also used in 1938 and 1939 in the computation of the diminished undistributed profits surtax then in force. Revenue Act of 1938, Sections 13 and 27.

First. The court erred in stating that the earnings transferred to the parent corporation were subject in its hands to the undistributed profits tax. Its mistake was in assuming that the statute surtaxes the mere retention of earnings whereas in fact the undistributed profits surtax is levied on the accumulation and retention of earnings and not on their retention alone. In computing the tax, the starting point is "net income" (Section 14). Under Section 112 (b) (6) the transfer from taxpayer to its parent corporation did not result in gain or loss to either, hence the earnings transferred were never included in the parent's "net income" and were not subject in its hands to either the normal tax or the undistributed profits surtax.

Second. Equally ineffective is taxpayer's attempt to justify allowing current earnings to escape the surtax altogether, despite the fact that they were not taxed or surtaxed to the principal stockholder to whom they were transferred; there is not the slightest indication that Section 27 (f) was intended to induce the shortening of corporate chains by exempting from the undistributed profits tax the earnings "transferred intact" from a subsidiary to a parent corporation. It is true that Congress expressed an intention to encourage the elimination of unnecessary corporations when in 1934 it decided to retain such of the tax free reorganization provisions of Section 112 as would encourage that

result.[13] Section 112 (b) (6) is an even more specific instrument for the same purpose, the essence of which first appeared in the Revenue Act of 1935.[14] Revenue Act of 1935, c. 829, Section 110, 49 Stat. 1014. But this purpose is entirely unrelated to the undistributed profits surtax, and there is no suggestion in the 1936 Act in general, or in Section 27 (f) in particular, or in the legislative history of either, to show that Section 27 (f) was drawn as an additional instrument to accomplish that end.[15] On the contrary the arbitrary and limited scope of the inducement which is said to be held out by Section 27 (f) is proof that none was intended; under Section 115 (h) only corporations

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[13] See H. Rep. No. 704, 73d Cong., 2d Sess., pp. 12–14 (1939–1 Cum. Bull. (Part 2) 554, 563–565); S. Rep. No. 558, 73d Cong., 2d Sess., pp. 16–17 (1939–1 Cum. Bull. (Part 2) 586, 598–599).

[14] See remarks of Senator George, 80 Cong. Rec. 8799, of Senator La Follette, 80 Cong. Rec. 10469.

[15] Certainly there is no such suggestion in the following Committee Report, which is the only one specifically bearing upon Section 27 (f). House Ways and Means Subcommittee Report, March 26, 1936, 74th Cong., 2d Sess., p. 6:

> In computing undistributed net income, it is recommended that the corporation be allowed a deduction for any part of liquidating dividends properly allocable to earnings and profits, but no deduction shall be given for the portion thereof properly chargeable to capital account.

In its brief below taxpayer made reference to Section 27 (j) of H. R. 12395, the Revenue Bill of 1936 as introduced in the House (Section 27 (i) of that bill as introduced in the Senate). The corporate tax on undistributed earnings as set up in the bill was graduated in such fashion as to afford

which liquidated by distributing property other than securities could take the advantage and by Section 115 (h) of the 1938 Act even that inducement was withdrawn.

Third. The Treasury's interpretation of Section 27 (f) does not act as a deterrent to liquidation of unnecessary subsidiary corporations, which would frustrate the purposes of Section 112 (b) (6). Taxpayer based its argument to the contrary in the court below upon a calculation showing that the total taxes paid by taxpayer and its parent corporation would have been less if taxpayer's current earnings had been distributed as ordinary dividends instead of in liquidation. But on other facts this would not be true.[16] Obviously, the statute

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a tax advantage in the formation of a lengthy chain of successive holding corporations, each of which could distribute part of its net income to the next. To discourage the establishment of such corporate chains Section 27 (j) reduced in certain circumstances the credit for dividends paid by a subsidiary corporation to its parent. Taxpayer attached significance to the elimination of Section 27 (j) from the Act as finally passed. This was wholly unwarranted. Section 27 (j) was eliminated by the Senate, as the Finance Committee explained, solely because the opportunities for evasion which it was designed to prevent were not offered by the final form of the bill. S. Rep. No. 2156, 74th Cong., 2d Sess., p. 16 (1939–1 Cum. Bull. (Part 2), 678, 688).

[16] If taxpayer had not liquidated but had declared an ordinary dividend of $1.80 per share (the amount per share of the distribution of earnings in liquidation in the instant case), and if the parent had distributed a comparatively small part of its earnings as dividends, the parent would have paid the same undistributed profits tax on taxpayer's earn-

cannot hope on any construction to achieve an exact correspondence between the amount of surtax which a corporation must pay if the earnings are retained and the amount of the normal taxes and surtaxes which the shareholders must pay if the earnings are distributed. Moreover, the argument overlooks the point that if the parent had redistributed the taxpayer's earnings to its own shareholders it could have established a dividends paid credit for taxpayer under the provisions of Article 27 (f)–1 (c) and neither corporation would have had to pay an undistributed profits tax on those earnings.

Taxpayer responds that Article 27 (f)–1 (c), allowing the subsidiary a credit for earnings declared as dividends by the parent corporation, is invalid; but in view of the substantial identity between the parent and the almost wholly owned subsidiary it is not an unreasonable construction of Section 27 to say that after the transfer of earned surplus from subsidiary to parent, its subsequent distribution by the parent is a distribution of the subsidiary's earnings. Articles 27 (f)–1 (a) and 27 (f)–1 (c), therefore, together provide a sound and reasonable scheme for the administration of Section 27 (f). The validity of the latter like the

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ings as has been charged to the taxpayer in the instant case, and in addition, would have paid a normal tax on 15 percent of those earnings, which it avoided in the instant case. Sections 14, 21; cf. Sections 13 (a) (2), 26 (b).

validity of the former must be conceded once it is recognized that the concept underlying Section 112 (b) (6) requires formal corporate changes to be ignored in applying the related provisions of the Act.[17]

3. SECTION 27 (h) SHOWS THAT FOR A NONTAXABLE DISTRIBUTION NO CREDIT IS ALLOWED

Section 27 (h), the final provision in Section 27, declares:

> (h) *Nontaxable Distributions.*—If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made, no dividends paid credit shall be allowed with respect to such part.

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[17] The reason for the failure of Commercial Credit Company to take advantage of Article 27 (f)–1 (c) does not appear. It declared a dividend of a large part of its earnings for that year. All that it needed to do was to pass a resolution allocating a portion of that or an increased dividend to taxpayer. The regulation was promulgated November 12, 1936, giving ample opportunity. The Treasury does not seek to disavow it. It seems scarcely becoming for taxpayer to attack the regulation made for its benefit simply because it failed to take the advantage.

But even if Article 27 (f)–1 (c) were invalid, the invalidity of Article 27 (f)–1 (a) by no means follows. A corporation is not automatically exempted from the surtax merely because it has no election to avoid it by making distribution. Cf. *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46; *Crane Johnson Co.* v. *Helvering*, 311 U. S. 54.

This concluding subsection appears to be applicable to all the preceding subdivisions of Section 27. It is a general warning in keeping with the purpose of the act that no credit shall be allowed for distributions which are not ordinarily taxable to the distributee. Like Section 27 (g), therefore, it modifies the provisions stating when the dividends paid credit shall be allowed and thus both furnishes a guide to their interpretation and prohibits any credits for nontaxable distributions which they might otherwise inadvertently have permitted. *Centennial Oil Co.* v. *Thomas*, 109 F. (2d) 359 (C. C. A. 5th), certiorari denied, 309 U. S. 690; cf. *May Hosiery Mills* v. *Commissioner*, 123 F. (2d) 858 (C. C. A. 4th) (Section 27 (g)).

On its face Section 27 (h) denies the credit claimed by taxpayer regardless of the meaning of Section 27 (f). As applied to distributions in liquidation the language may be inartistic for in terms it allows a credit only if the distribution is "a taxable dividend in the hands of * * * shareholders",[19] and a distribution in liquidation is not ordinarily a dividend within the meaning of the Revenue Acts. See *Hellmich* v. *Hellman*, *supra*. The Board and court below sought to avoid the

[19] The words limiting the phrase to shareholders "subject to taxation under this title" were inserted so as not to deny the credit for distributions to charitable corporations and others exempted from the income tax by Section 101. See H. Rep. 2475, 74th Cong., 2d Sess., p. 11 (1939–1 Cum. Bull. (Part 2) 667, 674).

difficulty by holding that subsection (f) required every distribution chargeable to profits on the corporate books to be treated as a "taxable dividend" for the purposes of all the provisions of Section 27, including subsection (h). This construction however, disregards the reference to "any part" of a distribution which is not taxable "in the hands * * * of the shareholders" which appears in subsection (h) but not in subsection (f). To give force to the quoted words it is necessary to read subsection (f) as converting a distribution in liquidation out of earnings into a dividend for the ordinary purposes of Section 27, but to read subsection (h) as prohibiting the credit for those parts of dividends or distributions of any kind which are exempted from tax in the hands of the recipients. Under this construction subsection (f) authorizes the credit in the instant case for the parts of the distribution which were received by the minority stockholders, while subsection (h) denies it for the part which was distributed tax free to the parent. The propriety of reading "dividend" in subsection (h) to include a liquidating distribution is confirmed by the caption "*Nontaxable Distributions*" which stands at the head of Section 27 (h). *Maguire* v. *Commissioner*, 313 U. S. 1, 9. More important, it alone is consistent with the purposes of the undistributed profits surtax. Thus, no conflict between Section 27 (f) and Section 27 (h) is created by interpreting Sec-

tion 27 (h) as generally denying any credit for nontaxable distributions and so denying taxpayer the credit claimed, even if Section 27 (f) were to be read as an accountant would read it.

But the constructional difficulties discussed by the Board and court below can be raised only by assuming that the Treasury's construction of Section 27 (f) is wrong. If it is right, the two sections are plainly harmonious. In truth, therefore, Section 27 (h) is conclusive evidence that Section 27 (f) is to be applied to deny a credit for a mere bookkeeping distribution of earnings and to allow a credit only for a "distribution of earnings" resulting in a taxable gain or loss.

4. THE APPLICABLE TREASURY REGULATION IS A REASONABLE INTERPRETATION OF SECTION 27 (f) WHICH MUST BE GIVEN CONTROLLING EFFECT

The most that can be said for any argument in support of the decision below is that it presents a possible alternative construction of Section 27 (f). Thus, taxpayer would give the words "distribution * * * chargeable to profits" their accounting sense. For purposes of argument, we may even assume that this construction would encourage the liquidation of some unnecessary corporate chains (albeit irrationally selected; see pp. 28–29 *supra*). Notwithstanding those assumptions, there would still remain open the alternative that Congress used the words in their tax sense to exclude transfers of

corporate surpluses from one corporation in liquidation to a parent corporation owning the bulk of its stock. It can be neither denied that the phrase "distribution chargeable to earnings" has often been given that meaning in tax law nor gainsaid that to give the phrase its tax meaning in Section 27 (f) would carry out the purposes of the undistributed profits surtax and correlate in a harmonious manner the provisions of Sections 112, 115 and 27 (f). In short, taxpayer cannot show that the words were used in their accounting, and not in their tax, sense. Both the Board and court below were aware of this, but concluded that they preferred the former interpretation.

Under these circumstances, however, the Treasury interpretation expressed in Article 27 (f)–1 (a) is controlling, whatever the choice between the two interpretations might be as an original question. Article 27 (f)–1 (a) is a just and reasoned application of established principles, which gives full effect and harmony to the language of the Act. *Helvering* v. *Wilshire Oil Co.*, 308 U. S. 90; *Maryland Casualty Co.* v. *United States*, 251 U. S. 342, 349; *Spring City Co.* v. *Commissioner*, 292 U. S. 182, 189; cf. *Textile Mills Securities Corp.* v. *Commissioner*, No. 34, this Term, decided December 8, 1941. It has been approved by the reenactment of the statute. See pp. 23–26 *supra*.

Moreover, it is not without significance that Section 27 (f) is a provision allowing an exemption

from tax. This Court held in *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46, 49:

> It is material that we are dealing here with a generally imposed surtax upon the undistributed net income of corporations, and that respondent's claim is for a credit in the nature of a specially permitted deduction. It has been said many times that provisions granting special tax exemptions are to be strictly construed. [Citing *Deputy* v. *du Pont*, 308 U. S. 488, 493; *White* v. *United States*, 305 U. S. 281, 292; *New Colonial Ice Co.* v. *Helvering*, 292 U. S. 435, 440.]

CONCLUSION

The decision of the Circuit Court of Appeals was erroneous and should be reversed.

Respectfully submitted,

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MARCH 1942.

APPENDIX

REVENUE ACT OF 1936, c. 690, 49 STAT. 1648

SEC. 13. NORMAL TAX ON CORPORATIONS.

(a) *Definition.*—As used in this title the term "normal-tax net income" means the net income minus the sum of —

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(2) *Dividends Received.*—The credit provided in section 26 (b). Such credit shall not be allowed in the case of a mutual investment company, as defined in section 48.

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SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—

(1) The term "adjusted net income" means the net income minus the sum of—

(A) The normal tax imposed by section 13.

(B) The credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

(C) In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933), the amount allowed as a credit under section 26 (d).

(D) In the case of a national mortgage association created under Title III of the National Housing Act, the amount allowed as a credit under section 26 (e).

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

17 per centum of the portion of the undistributed net income which is in excess of 20 per centum and not in excess of 40 per centum of the adjusted net income.

22 per centum of the portion of the undistributed net income which is in excess of 40 per centum and not in excess of 60 per centum of the adjusted net income.

27 per centum of the portion of the undistributed net income which is in excess of 60 per centum of the adjusted net income.

(c) *Adjusted Net Income Less Than $50,000.*—

(1) *Specified Credit.*—If the adjusted net income is less than $50,000 there shall be allowed a specific credit equal to the portion of the undistributed net income which is in excess of 10 per centum of the adjusted net

income and not in excess of $5,000, such credit to be applied as provided in paragraph (2).

(2) *Application of Specific Credit.*—If the corporation is entitled to a specific credit, the tax shall be equal to the sum of the following:

(A) A tax computed under subsection (b) upon the amount of the undistributed net income reduced by the amount of the specific credit, plus

(B) 7 per centum of the amount of the specific credit.

(d) *Exemption From Surtax.*—The following corporations shall not be subject to the surtax imposed by this section:

(1) Banks as defined in section 104.

(2) Domestic corporations which for any portion of the taxable year are in bankruptcy under the laws of the United States, or are insolvent and in receivership in any court of the United States or of any State, Territory, or the District of Columbia.

(3) Insurance companies subject to the tax imposed under section 201, 204, or 207.

(4) Foreign corporations.

(5) Corporations which, by reason of deriving a large portion of their gross income from sources within a possession of the United States, are entitled to the benefits of section 251.

(6) Corporations organized under the China Trade Act, 1922.

(7) Joint Stock Land Banks organized under the Federal Farm Loan Act, as amended.

(e) *Exempt Corporations.*—For corporations exempt from taxation under this title, see section 101.

(f) *Tax on Personal Holding Companies.*—For surtax on personal holding companies, see section 351.

(g) *Improper Accumulation of Surplus.*—For surtax on corporations which accumulate surplus to avoid sur tax on stockholders, see section 102.

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SEC. 21. NET INCOME.

"Net income" means the gross income computed under section 22, less the deductions allowed by section 23.

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SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(b) *Dividends Received.*—85 per centum of the amount received as dividends from a domestic corporation which is subject to taxation under this title. The credit allowed by this subsection shall not be allowed in respect of dividends received from a corporation organized under the China Trade Act, 1922, or from a corporation which under section 251 is taxable only on its gross income from sources within the United States by reason of its receiving a large percentage of its gross income from sources within a possession of the United States.

* * * * *

SEC. 27. CORPORATION CREDIT FOR DIVIDENDS PAID.

(a) *Dividends Paid Credit in General.*—For the purposes of this title, the dividends paid credit

shall be the amount of dividends paid during the taxable year.

(b) *Dividend Carry-Over.*—In computing the dividends paid credit for any taxable year, if the dividends paid during the taxable year are less than the adjusted net income, there shall be allowed as part of the dividends paid credit, and in the following order:

(1) Dividends paid during the second preceding taxable year in excess of the adjusted net income for such year, to the extent not needed as a dividends paid credit for the taxable year preceding the taxable year the tax for which is being computed; and

(2) Dividends paid during the first preceding taxable year in excess of the adjusted net income for such year.

No credit shall be allowed for dividends paid by a corporation prior to its first taxable year under this title.

(c) *Dividends in Kind.*—If a dividend is paid in property other than money (including stock of the corporation if held by the corporation as an investment) the dividends paid credit with respect thereto shall be the adjusted basis of the property in the hands of the corporation at the time of the payment, or the fair market value of the property at the time of the payment, whichever is the lower.

(d) *Dividends in Obligations of the Corporation.*—If a dividend is paid in obligations of the corporation, the amount of the dividends paid credit with respect thereto shall be the face value of the obligations, or their fair market value at the time of the payment, whichever is the lower. If the fair market value is lower than the face value,

then when the obligation is redeemed by the corporation, the excess of the amount for which redeemed over the fair market value at the time of the dividend payment (to the extent not allowable as a deduction in computing net income for any taxable year) shall be treated as a dividend paid in the taxable year in which the redemption occurs.

(e) *Taxable Stock Dividends.*—In case of a stock dividend or stock right which is a taxable dividend in the hands of shareholders under section 115 (f), the dividends paid credit with respect thereto shall be the fair market value of the stock or the stock right at the time of the payment.

(f) *Distributions in Liquidation.*—In the case of amounts distributed in liquidation the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, shall, for the purposes of computing the dividends paid credit under this section, be treated as a taxable dividend paid.

(g) *Preferential Dividends.*—No dividends paid credit shall be allowed with respect to any distribution unless the distribution is pro rata, equal in amount, and with no preference to any share of stock as compared with other shares of the same class.

(h) *Nontaxable Distributions.*—If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made, no dividends paid credit shall be allowed with respect to such part.

* * * * *

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * * * * *

(b) *Exchanges Solely in Kind.*— * * *

(6) *Property received by corporation on complete liquidation of another.*—No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation. For the purposes of this paragraph a distribution shall be considered to be in complete liquidation only if—

(A) the corporation receiving such property was, on the date of the adoption of the plan of liquidation, and has continued to be at all times until the receipt of the property, the owner of stock (in such other corporation) possessing at least 80 per centum of the total combined voting power of all classes of stock entitled to vote and the owner of at least 80 per centum of the total number of shares of all other classes of stock (except non-voting stock which is limited and preferred as to dividends), and was at no time on or after the date of the adoption of the plan of liquidation and until the receipt of the property the owner of a greater percentage of any class of stock than the percentage of such class owned at the time of the receipt of the property; and

(B) no distribution under the liquidation was made before the first day of the first taxable year of the corporation beginning after December 31, 1935; and either

(C) the distribution is by such other corporation in complete cancellation or redemption of all its stock, and the

transfer of all the property occurs within the taxable year; in such case the adoption by the stockholders of the resolution under which is authorized the distribution of all the assets of such corporation in complete cancellation or redemption of all its stock, shall be considered an adoption of a plan of liquidation, even though no time for the completion of the transfer of the property is specified in such resolution; or

(D) such distribution is one of a series of distributions by such other corporation in complete cancellation or redemption of all its stock in accordance with a plan of liquidation under which the transfer of all the property under the liquidation is to be completed within three years from the close of the taxable year during which is made the first of the series of distributions under the plan, except that if such transfer is not completed within such period, or if the taxpayer does not continue qualified under subparagraph (A) until the completion of such transfer, no distribution under the plan shall be considered a distribution in complete liquidation.

If such transfer of all the property does not occur within the taxable year the Commissioner may require of the taxpayer such bond, or waiver of the statute of limitations on assessment and collection, or both, as he may deem necessary to insure, if the transfer of the property is not completed within such three-year period, or if the taxpayer does not continue qualified under subparagraph (A) until the completion of such transfer, the assessment and

collection of all income, war-profits, and excess-profits taxes then imposed by law for such taxable year or subsequent taxable years, to the extent attributable to property so received. A distribution otherwise constituting a distribution in complete liquidation within the meaning of this paragraph shall not be considered as not constituting such a distribution merely because it does not constitute a distribution or liquidation within the meaning of the corporate law under which the distribution is made; and for the purposes of this paragraph a transfer of property of such other corporation to the taxpayer shall not be considered as not constituting a distribution (or one of a series of distributions) in complete cancellation or redemption of all the stock of such other corporation, merely because the carrying out of the plan involves (i) the transfer under the plan to the taxpayer by such other corporation of property, not attributable to shares owned by the taxpayer, upon an exchange described in paragraph (4) of this subsection, and (ii) the complete cancellation or redemption under the plan, as a result of exchanges described in paragraph (3) of this subsection, of the shares not owned by the taxpayer.

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SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * * *

(15) *Property Received by a Corporation on Complete Liquidation of Another.*—If the property was received by a corporation

upon a distribution in complete liquidation of another corporation within the meaning of section 112 (b) (6), then the basis shall be the same as it would be in the hands of the transferor.

* * * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this title (except in section 203 (a) (3), and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

(c) *Distributions in Liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liqui-

dation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. Despite the provisions of section 117 (a), 100 per centum of the gain so recognized shall be taken into account in computing net income, except in the case of amounts distributed in complete liquidation of a corporation. For the purpose of the preceding sentence, "complete liquidation" includes any one of a series of distributions made by a corporation in complete cancellation or redemption of all of its stock in accordance with a bona fide plan of liquidation and under which the transfer of the property under the liquidation is to be completed within a time specified in the plan, not exceeding two years from the close of the taxable year during which is made the first of the series of distributions under the plan. In the case of amounts distributed (whether before January 1, 1934, or on or after such date) in partial liquidation (other than a distribution within the provisions of subsection (h) of this section of stock or securities in connection with a reorganization) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits.

(d) *Other Distributions from Capital.*—If any distribution (not in partial or complete liquidation) made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not a dividend, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided

in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property.

* * * * *

(g) *Redemption of Stock.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

(h) *Effect on Earnings and Profits of Distributions of Stock.*—The distribution (whether before January 1, 1936, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities or stock or securities in another corporation shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

(i) *Definition of Partial Liquidation.*—As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

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REVENUE ACT OF 1938, C. 289, 52 STAT. 447

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

* * * * * *

(h) *Effect on Earnings and Profits of Distributions of Stock.*—The distribution (whether before January 1, 1938, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property or money, shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities, property or money, was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

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TREASURY REGULATIONS 94, PROMULGATED UNDER REVENUE ACT OF 1936

ART. 27 (f)-1. *Dividends paid credit for distributions in liquidation.*—(a) *Distributions which diminish earnings or profits.*—To the general rule that the dividends paid credit is allowable only with respect to taxable dividends paid, section 27 (f) makes one exception, namely, for that part of an amount distributed in liquidation which, under the Act, constitutes a distribution of, and is properly chargeable to, earnings or profits accumulated after February 28, 1913. Thus, a distribution either in complete or partial liquidation of a corporation is treated by the Act as one constituting in part a distribution of, and being properly chargeable to, earnings or profits, if—

(1) Under the provisions of section 115 (c), the amounts distributed in liquidation are treated as received in payment in exchange for the stock; and

(2) Under the provisions of section 112, the gain or loss, if any, from such exchange is recognized.

In such a case, a dividends paid credit is allowable for the amount actually involved in such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, even though the method of taxation of the distribution is that ordinarily employed with respect to the gain or loss realized and recognized upon an exchange, rather than that employed with respect to a taxable dividend.

On the other hand, certain transactions described in sections 112 and 115 are treated, for the purposes of the Act, not as distributions to the shareholders of earnings or profits, but as transfers of

such earnings or profits intact to another corporation in whose hands such earnings or profits, being available for distribution by it as dividends to its shareholders, have essentially the same status for the purposes of the Act as earnings or profits derived from its own operations. Characteristic of these transactions is the circumstance that the gain or loss realized from the receipt by the shareholders of property is not recognized by the Act. No dividends paid credit is allowable with respect to such transactions.

(b) *Amount properly chargeable to earnings or profits.*—In the case of a distribution in liquidation with respect to which a dividends paid credit is allowable (see paragraph (a) of this article) the amount of the credit is equal to the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913. To determine the amount properly chargeable to the earnings or profits accumulated since February 28, 1913, there must be deducted from the amount of the distribution that part allocable to capital account. The capital account, for purposes of these regulations, includes not only amounts representing the par or stated value of the stock with respect to which the liquidating distribution is being made but also that stock's proper share of the paid-in surplus, and such other corporate items, if any, which, for purposes of income taxation, are treated like capital in that they are not taxable dividends when distributed but are applied against and reduce the basis of the stock. The remainder of the distribution in liquidation is, ordinarily, properly chargeable to the earnings or

profits accumulated since February 28, 1913. The application of this paragraph may be illustrated by the following example:

Example: The Y Corporation was organized on January 1, 1910, with an authorized and outstanding capital stock of 2,000 shares of common stock of a par value of $100 each and 1,000 shares of participating preferred stock of a par value of $100 each. The preferred stock was to receive annual dividends of $7 per share and $100 per share on complete liquidation of the corporation in priority to any payments on common stock, and was to participate equally with the common stock in either instance after the common stock had received a similar amount. However, the preferred stock was redeemable in whole or in part at the option of the board of directors at any time at $106 per share plus its proportion of the earnings of the company at the time of such redemption. In 1910 the preferred stock was issued at $106 per share, for a total of $106,000, and the common stock was issued, at $100 per share, for a total of $200,000. On July 15, 1936, the company had a paid-in surplus of $6,000, consisting of the premium received on the preferred stock, earnings or profits of $30,000 accumulated prior to March 1, 1913, and earnings or profits accumulated since February 28, 1913, of $75,000. On July 15, 1936, the option with respect to the preferred stock was exercised and the entire amount of such stock was redeemed at $141 per share or a total of $141,000 in a transaction upon which gain or loss to the distributees resulting from the exchange was determined and recognized under the Act, such transaction being only a par-

tial liquidation under section 115 (c). The amount of the distribution allocable to capital account was $116,000 ($100,000 attributable to par value, $6,000 attributable to paid-in surplus, and $10,000 attributable to earnings or profits accumulated prior to March 1, 1913). The remainder, $25,000 ($141,000, the amount of the distribution, less $116,000, the amount allocable to capital account) is properly chargeable to the earnings or profits accumulated since February 28, 1913, and is allowable as a dividends paid credit.

(c) *Credit in respect of earnings or profits transferred under certain tax-free transactions.*—If, as a result of one or more transactions described in Section 112, a corporation's earnings or profits accumulated after February 28, 1913, and its undistributed earnings or profits of the taxable year, shall have become the earnings or profits of another corporation subject to distribution as dividends by such other corporation, any dividend paid by the transferee corporation during that portion of the transferor's taxable year subsequent to the consummation of such tax-free transaction may, subject to the provisions of section 115, be apportioned and allocated to the transferor as a distribution out of such earnings or profits of the transferor. The resolution of the board of directors of the transferee shall specifically designate the distribution, or part thereof, so apportioned and allocated. For the purposes of the dividends paid credit, any such distribution so allocated shall be treated as a dividend paid only in the computation of the credit allowable to the transferor, and must be consistently so treated by both corporations for the cur-

rent and succeeding taxable years. Each corporation shall file as a part of its return for the taxable year involved, (1) a statement setting forth concisely all of the material facts, including the date and the character of the transaction under section 112, the status at that time of the earnings or profits of both corporations, the date and amount of all dividend distributions subsequently made, and the particular distribution or portion thereof designated as effecting a distribution of the earnings or profits of the transferor corporation; and (2) a certified copy of the resolution of the board of directors of the transferee corporation with respect to the distribution. No dividends paid credit based upon such apportionment and allocation will be allowed unless the Commissioner is satisfied that the transferor corporation is entitled thereto pursuant to the provisions of this paragraph and that there has been a full compliance with the requirements of this paragraph. The provisions of this paragraph may be illustrated by the following example:

Example: The P Corporation, which keeps its books and makes its income tax returns on the basis of a fiscal year ending March 31, owned all of the capital stock of the S Corporation. The S Corporation, which keeps its books and makes its returns on the calendar year basis, was completely liquidated on December 1, 1936. At that time, the S Corporation had earnings or profits accumulated subsequent to February 28, 1913, in the amount of $50,000, in addition to earnings or profits for 1936 of $20,000, and an adjusted net income of $45,000. It had paid no dividends prior

to its liquidation. The P Corporation had earnings or profits accumulated subsequent to February 28, 1913, in the amount of $60,000 in addition to earnings or profits of the taxable year computed as of the end of the year in the amount of $80,000, and an adjusted net income in the amount of $60,000. The P Corporation pays dividends as follows: June 15, 1936, $25,000; September 15, 1936, $25,000; December 15, 1936, $25,000; and March 15, 1937, $25,000. No portion of the dividends paid on June 15 and September 15 prior to the liquidation and no portion of the dividend paid on March 15, 1937, after the close of the taxable year of the S Corporation may be allocated to the S Corporation. The dividend paid on December 15 may, by appropriate corporate action, be made as one effecting a distribution out of the current earnings or profits of the S Corporation to the extent of $20,000. No part of that distribution may be allocated to the S Corporation's accumulated earnings or profits since, under section 115 (b), the earnings or profits of the P Corporation and the S Corporation for the taxable year ($100,000) are sufficient in amount to cover all the distributions made during that year ($100,000).

* * * * * *

ART. 27 (h)-1. *Nontaxable distributions.*—No dividends paid credit shall be allowed with respect to any part of the distribution by a corporation to its shareholders which is—

(a) not out of earnings or profits of the taxable year or out of earnings or profits of the corporation accumulated subsequent to February 28, 1913 (see section 115), or, in the case of distributions in

liquidation, not properly chargeable to earnings or profits of the corporation accumulated after February 28, 1913, under article 27 (f)–1;

(b) in the case of a corporation which was classified as a personal service corporation under the Revenue Act of 1918 or the Revenue Act of 1921, out of earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 or section 218 of the Revenue Act of 1921 (see section 115 (e)); or

(c) a distribution in stock of the corporation or rights to acquire its stock which does not constitute income to its shareholders within the meaning of the sixteenth amendment to the Constitution (see section 115 (f) and articles 115–3 and 115–4).

The effect of subsections (g) and (h) of section 27 is that no dividends paid credit is allowed with respect to any distribution unless each of the shareholders of that class, who are subject to taxation under Title I for the period in which the distribution is made, receives a taxable dividend as a result of the distribution.

The application of section 27 (h) may be illustrated by the following examples:

Example (1): A, B, C, and D are the shareholders of the Y Corporation, which makes its returns on the calendar year basis, D being an educational corporation exempt from income tax under section 101. On July 15, 1936, the Y Corporation paid a dividend (within the meaning of section 115) in cash of $1,000. A and B make their returns on the calendar year basis, but C makes his return on the basis of the fiscal year ending July 31. The

Y Corporation is entitled to a dividends paid credit in the amount of $1,000 with respect to the dividends paid on July 15.

Example (2): If the facts in the preceding example are the same, except that A and B make their returns on the basis of the fiscal year ending July 31, the Y Corporation is entitled to a dividends paid credit in the amount of $1,000 with respect to the dividends paid on July 15.

* * * * *

ART. 115–11. *Effect on earnings or profits on certain tax-free exchanges and tax-free distributions.*—If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under section 112 (b) (6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

The general rule provided in section 115 (b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112 (g) of the Revenue Act of 1932); or

(B) in any taxable year (beginning before January 1, 1936, or on or after such date) in exchange for its stock or securities (see section 112 (b) (3)) if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

A distribution described in paragraphs (1) and (2) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange.

For the purposes of this article, the terms "reorganization" and "party to the reorganization" shall, for any taxable year beginning before January 1, 1934, have the meanings assigned to such terms in section 112 of the Revenue Act of 1932, and for any taxable year beginning after December 31, 1933, and before January 1, 1936, have the meanings assigned to such terms in section 112 of the Revenue Act of 1934.

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